DOW THEORY LETTERS INC.

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36 Letters per Year—$60.00 Annually

Registered with the Securities Exchange Commission

January 17, 1969 Letter 416

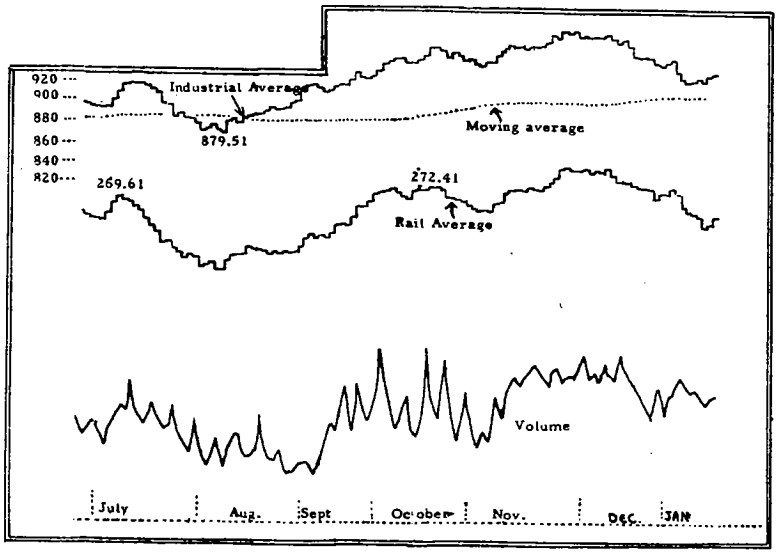
THE MARKET: In starting this Letter, I would almost prefer that my subscribers read the later section in this report entitled "Dow's Theory" first. For I believe there is a danger in assuming microscopic or short-term views of what now is occurring.

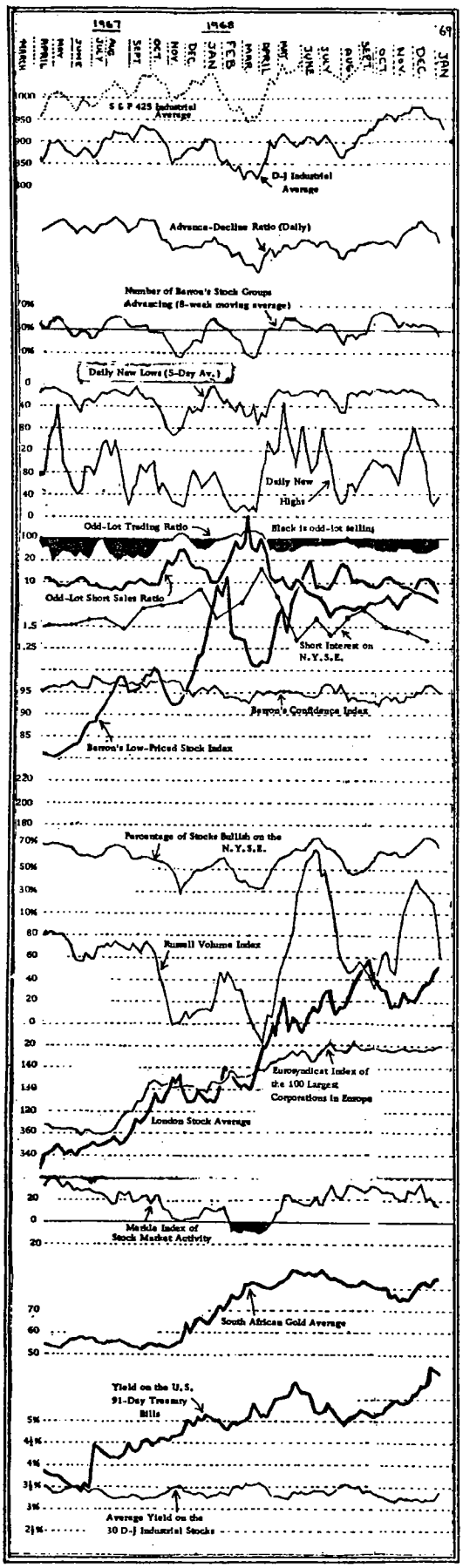
Following the widely "heralded" year-end rally and "new year's reinvestment" period, it became obvious to all that the market had not done what it was supposed to do. In fact, rather then hurdle the 1000 level in expected fashion, the Dow promptly dropped 64 points to the December 21 low of 921.25.

In reading dozens of investment services this week, I note one outstanding attitude—confusion. Those who were bullish are now hedging, those who were on the fence are still on the fence, those who were bearish now feel that maybe the decline has gone too far too fast, and they are moving towards a neutral position at least for the short term. It is clear that the frenzied bullishness of 1968 will not die with the first 1969 decline. Few take the drop to the Dow 920's as anything more than a normal correction. With the exception of a tiny handfull of market observers, Granville, Schaefer, myself, no one is thinking in terms of the resumption of a primary bear market.

Personally, I believe that the great and deceptive bear market rally of 1966-68, a rally which was fed by almost unprecedented inflationary fires, is now in extreme trouble. Currently, the Federal Reserve Board is leaping almost eagerly on any statistic of business decline in their efforts to prove that inflation is easing. Economic leaders point with "pride" to contracting auto sales and lower December retail sales. The surtax, we are told, is beginning to take effect.

One of the points the great Dow Theorist, Robert Rhea, made was that Government can whip a bull market into froth and frenzy, but all the money in the U. S. Treasury cannot stop the forces of deflation once they take hold. I view with mixed emotions the slowly emerging business statistics which point to a possible slowing down of the boom. If the deflationary pressures really begin to take hold, if the stock market starts collapsing in earnest, if business and world commerce ebb, I would guess that the Federal Reserve Board and our economic leaders will




1967
1968
69
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Sales Ratio
Short Interest on N.Y.S.E.
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of Stocks Bullish on the N.Y.S.E.
Russell Volume Index
Eurosyndicat Index of the 100 Largest Corporations in Europe
London Stock Average
Merkle Index of Stock Market Activity
South African Gold Average
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

 take an entirely different view of the results.

With the prime rate now at an historic high of 7%, it is assumed that if things start turning sour all that has to be done is to reduce interest rates, lower the discount rate, flood the nation with more money, and lo and behold, the boom will start up again. People forget that between late-1929 and late-1930 the discount rate was lowered no less than eight times without making a dent in the forces of deflation. To put it another way, sooner or later the primary forces will express themselves, and when they do no Congress, no President, no Treasury or group financiers can be expected to halt the movement.

Consider Mr. Nixon's predicament. As the Cleveland Trust's bank letter puts it, "President Nixon cannot both be loved and successful in 1969." I would guess that Mr. Nixon is now quite used to periods of defeat and adversity, and I would guess that he is going to attempt to do what is "right," rather than go for consensus and popularity. This could mean a firm stand against inflation during 1969. If so, the stock market and the economy will be facing pressure unlike any they have faced in many a decade.

I still do not like to get caught up totally in the near-term. Therefore, I ask my readers to think about the big picture. A seventeen-year bull market started in 1949 and ended in 1966. Historically, primary bear markets tend to last about a third as long as the bull market which preceded them. If so, we might expect about a five or six year bear market starting with the February, 1966 top.

Here, in early 1969, three years have passed since the 1966 high, and the Dow Industrials are still within roughly 70 points of the bull market high. Based on the "one-third as long" observation, we could expect this bear market to end around 1971 or perhaps 1972. This suggests that the bear forces (following three years of actual backing-and-filling) have a long way to go on the downside if they are really going to express themselves. It also means that with three years of fluctuating action behind them, the Averages could make up for lost time if they decide to go down in earnest.

Of course, no one knows what the world governments will try to do if the whole fabric of international prosperity starts coming apart at the seams. The price of gold could be doubled or tripled, unprecedented inflationary measures might be attempted, anything could happen, and perhaps something may be uncovered which would mitigate the bear forces.

Nevertheless, I continue to urge my subscribers to stay with the Dow Theory and the relatively classical approach to Wall Street. Dow's Theory never said that there could not be fantastic bear market (upward) corrections, Dow's Theory never claimed that frenzied excesses could not accompany bear rallies. But Dow's Theory also observes that bear markets tend ultimately to be in proportion to the bull market which precedes them. The story of the bear market has not been told yet, and until it is I warn my subscribers that "caution" has always been the best policy during a primary bear market. The heroes of a bear market rally are quickly forgotten when the primary trend resumes its downward course. I believe we are near the downward part of the second phase of this bear market now.

DOW'S THEORY: Wall Street loves to use Dow's classic Theory — whenever it suits the Street's purposes. When Dow's Theory is at variance with what the investment community wants, it is ignored.

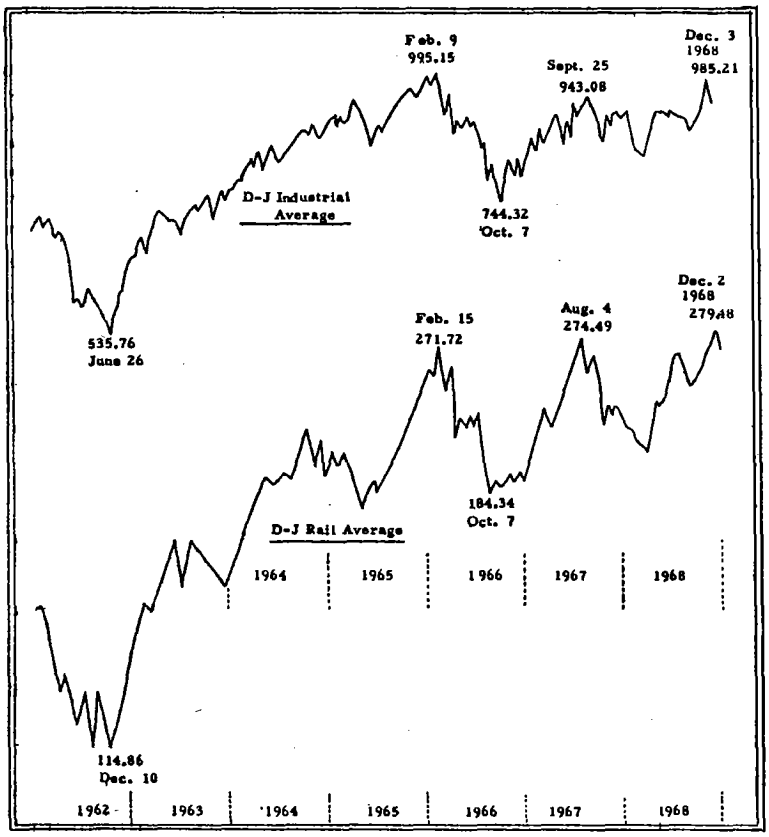
Right now, referring to the long-term chart (page 3), Dow's Theory is saying something that few (very few) stock analysts want to be reminded of. One of the basic tenets of Dow's Theory is that the two Averages, Industrials and Rails, must confirm each other through corresponding points. A persistent refusal to confirm may mean that the movement leading to the non-confirmation was false or deceptive.

Note that on February 9, 1966, the Averages set bull market highs at 995.15 and 271.72 respectively. As far as the Dow Theory is concerned, a movement is terminated at the point where the two Averages recorded their last joint highs. Therefore, as things stand (and assuming that Industrials do not better their 1966 peak) history will record that the great bull market which started on June 13, 1949, ended on February 9, 1966.

From the February, 1966 highs, a major bear market might normally have developed. But due to unprecedented measures taken by the Federal Reserve Board (such as flooding the nation with paper currency), the primary bear forces were held in check. Nevertheless, it is notable from the historical standpoint that since February, 1966, two major non-confirmations have occurred in the Averages.

The first took place during the August-September, 1967 period, when Rails ran up to new all-time highs at 271.72. The Rail highs were not confirmed by Industrials which stopped at 943.49, 52 points under their 1966 bull market top. The second major non-confirmation developed during December, 1968, when Rails again pushed up to all-time highs at 279.48. Again, Industrials refused to confirm by bettering their 1966 peak. This time Industrials halted their climb at 985.21, just 10 points below the 1966 peak.

I would say (based on the records) that two major non-confirmations such as those which appeared during 1967 and 1968 set up a dangerous situation. It means that although Rails have set three successive all-time highs, Industrials over a three year period have refused to confirm. If the Averages will not confirm in one direction, the normal expectation is that they will ultimately confirm each other in the opposite direction.



Obviously, Industrials could still better their 1966 high, thus removing the whole danger of the three-year set of non-confirmation. But unless they do, Dow's Theory will be saying that the odds favor confirmation on the downside and the resumption of the primary bear trend.

One thing to consider is that Industrials have failed to confirm during one of the greatest inflationary and speculative eras in the history of American finance. One wonders what it would take in 1969 to produce an Industrial confirmation. My guess is that the forces of inflation have "shot their wad," as they used to say in the army. From here on, I expect deflationary forces to loom larger and more important. If so, the chances are growing progressively slimmer that a new Industrial high (above 995.15) will be seen prior to the full expression of a major bear market.

1969 BEGINS: The year 1969 started with a bang as the Dow Industrial Average opened the first hour at 946.66—then headed down. By January 7 the Dow had fallen into the 925 area, 75 points below the "magic 1000 level," and the widely-held hopes that 1000 would be bridged began to fade.

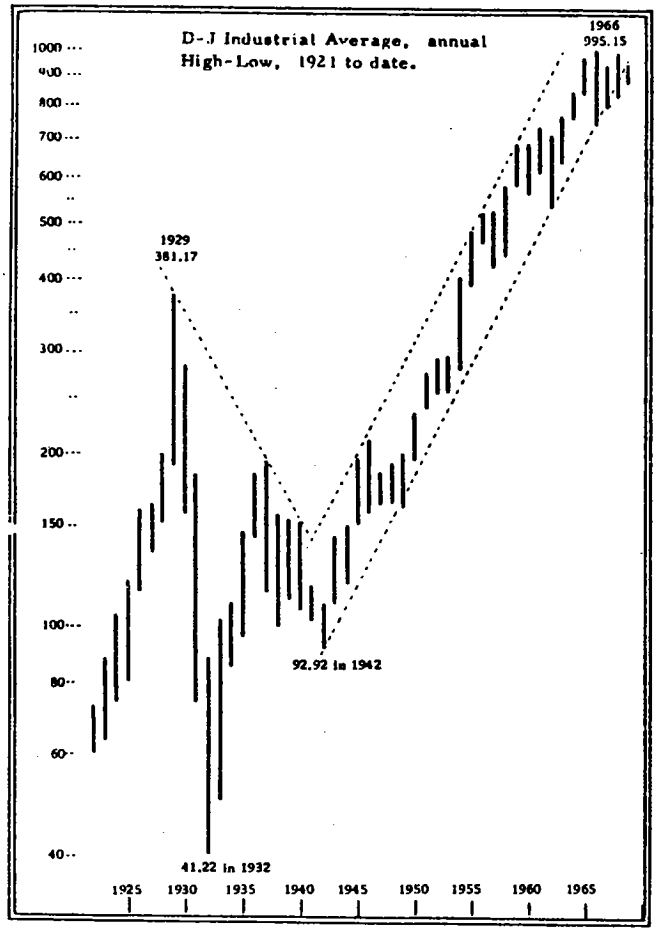
One thing that interests me is my chart (page 4) of the yearly high-low of the Dow Industrials going back to 1921. Referring to the great rising channel carrying from 1942 to 1967, I wondered if it was not significant that Industrials opened the year 1969 below the lower trendline of the channel (in previous Letters I noted that the limits of the lower trendline would be at 950 during 1969. This is the first year since 1942 in which the Dow immediately opened below the channel, then continued to decline. Such action could prove to be very significant.

As I look at this annual chart, it appears to me that the price movement from 1965 to the present is all part of a massive top, perhaps the largest top in market history. Now here is what I think is a fascinating observation. The high and low for the Dow Industrials during the single year 1966 were 995.15 and 744.32. This is a range of 251 points. Note that all the price movement during the years 1964, 1965, 1966, 1967 and 1968 was contained within the 1966 range. In other words, for five years the Dow has been fluctuating within the 1966 price range.

This type of action has not been seen since the 1945-1949 area, which was an area of accumulation. In my mind, just as the 1945-49 area was one of accumulation, the 1965-68 area constitutes one of distribution. Of course, what is so phenomenal is the sheer size of the 1965-68 area.

I would say that the major bear movement would be on if Industrials broke below the 1966 low of 744.32. A breaking of 744.32 would penetrate the whole area of the past six years on the downside. Such a move would also take the Dow far out of the great rising channel into the declining part of the second phase of the bear market.

NOTES & QUOTES: From an Eliot Janeway interview with Sander Landfield, partner in Carlisle & Jacquelin, and one of the most respected experts on Wall Street: in response to a question regarding what the market was on its way to in 1969 .....Answer "The market is in the process of setting a major top. What form it will take, I don't know. Many believe the Dow-Jones will go to 1050 or more."



In response to a question as to what the small investor is doing: "Odd-lot investors have been sellers on balance in New York exchange stocks. But there is reason to believe that the proceeds from these sales are finding their way into more speculative areas away from the primary market. Where there is a greater degree of public interest in the stocks we handle, it is in the same type of stocks as those of the performance funds. In those types of stocks there is a constant change in the pattern of buying and selling."

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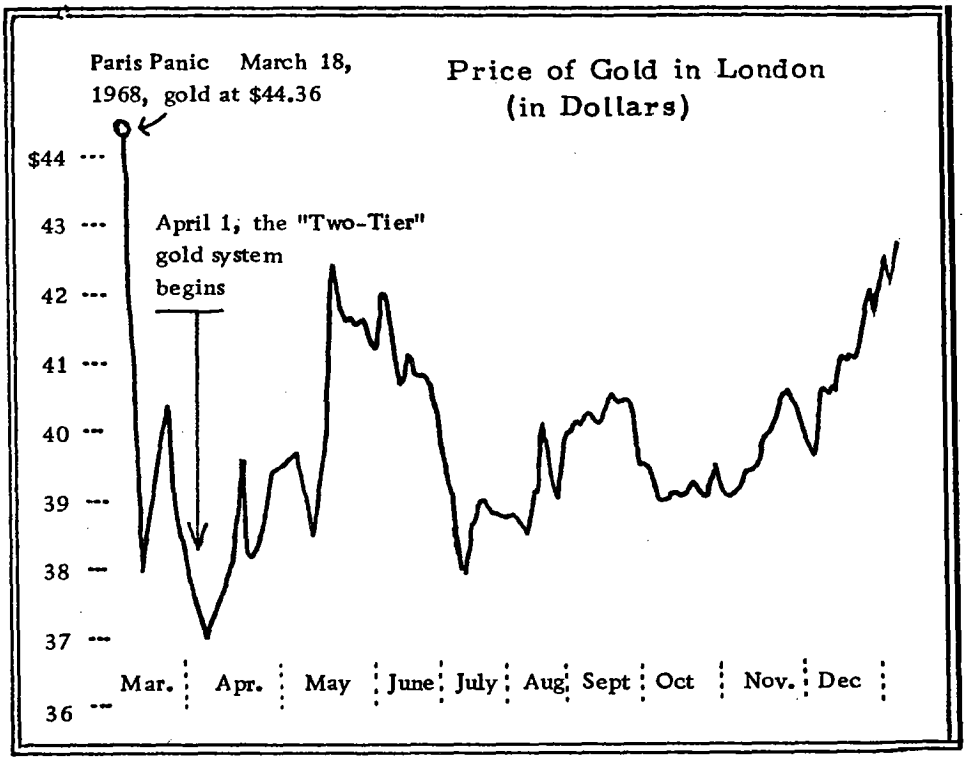
Certificate of Deposit (C/D) losses at N.Y.C. banks ran to above $1 billion in December with experts guessing that another billion will be lost in January (this money will be going to higher yielding debt instruments such as Treasury bills).

Commenting on the situation, Charles Brophy, editor of the Weekly Bond Buyer states (Jan. 6): "Even in the banking business, a run-off (loss) of a billion dollars in C/D's in December and January is no small matter, although the banks are still liquid enough and prepared enough to stand that much of the gaff. But the squeeze is a matter of dynamics, not statistics, and with a continuance of a Federal Fund rate, and Treasury bill rate, uncomfortably around or above the C/D ceiling, it won't be long before the lines start cutting into the banking bones rather than just the flesh."

From the latest (Jan. 8) Janeway Service: "A new injection of excess confidence is a prerequisite to the major market break which we expect after the rally from the present corrective reveals that it wasn't a corrective after all. Expectations of a corrective drop in money rates are one vital ingredient of the present misplaced excess of confidence. Another is the willingness to buy stocks blind despite the brewing money storm, on the theory that the economy is moving forward— as if booming demand pressures would not bring the money storm closer and make it worse. Still another ingredient is confidence that the markets have been freed to go their merry way without worry, as if they were not in fact operating in the shadow of the world political crisis— which isn't getting any better and which is at the root of the fiscal pressures which are the driving forces of inflation. Meanwhile, the turn-of-the-year market correction, against a background of rising confidence that the worst is over on the money front, looks like it's building a base from which the market faithful can jump into a pretty nasty bear trap."

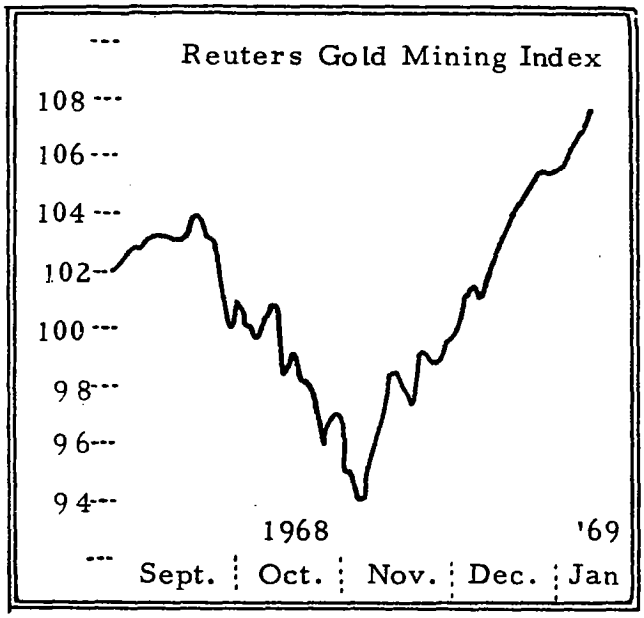
From the January Bolton-Tremblay Bank Credit Analyst (edited by Donald Storey): "It's a safe bet to say that the coming year will be a most exciting one in the lifetime of most investors. They are likely to be put to the most trying tests in their efforts to preserve capital, let alone appreciate it." And two more informative Storey quotes: "Another aspect of money that has become paramount internationally and not unimportant domestically is that it must be a store of value. A vivid reminder of the difference in quality of gold and U.S. dollars is the fact that gold is held for appreciation while the bond market attests to the disinterest in dollars as a store of value."....."The basic domestic malaise remains this deterioration of fundamental liquidity. We will see a further extension of the long term money and credit trends with increasing deflationary pressure on the economy and the increasing risk of financial panic."

From Joseph Granville's Jan. 10 report: "......A few short weeks later a dramatic reversal has taken place in the national psychology. It has suddenly become apprehensive and quite fearful of the future. Now the buying of things is in the process of going out of vogue. The new desire is to get rid of things and accumulate dollars. This new deflationary psychology is certain to have far reaching effects, and it may extend itself to the identical limits that the inflationary psychology reached. If so, then the reversal is going to be painfully extended. The current posture of all the important technical indicators implies that what we have seen since December 3rd in the market (a 64 point drop) is merely a brief prelude, the opening movement in a long symphony of retreat."



GOLD: Our Treasury Department must be wearying of waiting for the price of gold to fall out of bed. Treasury predictions of a drop in the price of gold below $35 per ounce now seems like pathetic wishful thinking. It is obvious that at $35, Europeans would take all the gold offered for sale. But the fact is that gold now seems to have a floor above $41 per ounce, with recent prices above $42 per ounce. On January 15 the London price of gold jumped to $42.75, highest level since the two-tier gold system was put into effect. Far from discouraging gold hoarders, speculators and hedgers, the steady rise in the price of gold has served only to make them skeptical of the occasional reactions in price. Those who purchased gold below $40 are now patiently waiting for profits of 20% or more.

Meanwhile, the persistent weakness in the dollar and pound are making obsolete all former talk of removing gold as a monetary reserve. Gold is here to stay; it has outlasted all its detractors over the last 5,000 years, including its latest detractor Treasury Secretary Fowler.



I have been watching the new sensitive Reuters gold share index (chart included), and note that from early November this index has been climbing steadily higher. This reflects gathering strength in most of the mining trusts and in the South African gold mining shares themselves.

I have shown two typical charts of the South African mining shares, both of them often recommended in these reports. The charts are from the excellent Kaffir Chart Service of Palisades Park, N.J. 07650. The charts show both the London price of these shares and the American Depository Receipt price (the latter shown by the line above the London high-low daily prices).

President Steyn has joined a handful of other gold shares in moving to an all-time high. A beautiful base was built in Steyn during September to December, and this stock has now doubled in price from where it was originally recommended in these reports a few years ago.

Western Deep, one of S.Africa's greatest gold mines, was first recommended here at a price of 9½. Now at a bid price of about 17 3/4, the stock is moving in on its highs of May, 1968. Here we see a long base stretching from July to early December, 1968, and then the breakout starting in late December.

A few of the mining trusts are now acting very well, with Anglo-American now at an all-time high (the trusts are holding companies or literally closed-end funds specializing in mining shares). One trust I like particularly well at this time is Charter Consolidated, and as seen on the chart this trust has the advantage of selling (on an ADR basis) at almost no premium over its overseas price. The small yearly range chart shows how well this relatively new mining trust has acted over the past four years.

SANTA BARBARA S&L SELLS U.S. SECURITIES AT LOSS

Financial Corp. of Santa Barbara announced its subsidiary, Santa Barbara Savings & Loan Assn., has sold substantially all its portfolio of government securities at a loss of $950,000.

Proceeds from the $16 million sale were re-invested in other, higher-yielding government securities, and the loss will ultimately be overcome, the company said.

Company executives had previously forecast net income from operations this year at between $1.35 and $1.40 per share. Based on the 980,089 shares outstanding, operating income would be more than $1.3 million. However, the non-recurring loss would reduce net income to about $400,000.

NEWS CLIP OF THE WEEK: This little article was buried in a recent issue of the L.A. Times. It demonstrates what can happen when an institution decides to bail out in a collapsing bond market. Santa Barbara S & L is probably typical of hundreds of other institutions which are now locked into large bond portfolios at large paper losses. Few people realize the billions which are lost (at least on paper) when the bond market sags to lows as it has been doing during 1968-69.